Ec320 Lecture 22
Microfinance: Achievements, Recent Challenges and Future Prospects

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Backdrop

- During1950-80, many Asian developing countries witnessed large expansions in state-subsidized lending to rural poor
- Abysmally low targeting and repayment records
- Huge fiscal strain on governments, generating fiscal crises (eg India in early 1990s)
- Key problem: formal financial institutions cannot lend to the poor since they lack assets that can serve as collateral; do not know how to select creditworthy borrowers, or ensure loans are repaid
- Generates high levels of exclusion of poor from formal finance

Financial Exclusion:Evidence from West Bengal sample

Source	Proportion of Loans	Interest Rate	Duration days	% Collateral
Informal Lenders	62	25.8 (22.2)	124 (31)	2
Family or Friends	5	19.7 (13.4)	164 (97)	4
Coop	24	15.5 (3.9)	317 (96)	76
Govt Banks	6	11.4 (4.7)	269 (119)	84

Enter Microfinance Institutions

- Starting late 1970s, non-profit non-governmental institutions Grameen Bank and BRAC in Bangladesh get started
- The movement grows in the 1990s, spreads to other LDCs, gathers further momentum world-wide in the 2000's
- 2009: estimated 10000 MFIs world-wide
- *2009 State of Microcredit Summit Report*, survey of 3600 participating MFIs: 154 million clients
- Mainly in Asia-Pacific region: 129 million
- 9.1 m. in s-s-Africa, 7.7 m. in Latin America, 3.3 m. in MENA

MFIs: Composition

- Size distribution quite skewed: 2% of MFIs account for 88% of the market
- Geographically quite skewed: Indian MFIs dominate (NABARD 49 m., SKS 1.5 m.), followed by Bangladesh (Grameen 7.4 m., BRAC 6.4 m.), Thailand, Vietnam, Indonesia
- Some international MFIs such as Accion International (3.7 m.)
- 62% of MFIs are non-profit, remaining are for-profit
- Non-governmental, though often relying on credit supplied by state banking system (NABARD in India, BAAC in Thailand)

Targeting and Repayment

- 68% of clients world-wide are extremely poor (EP: live below $1 a day)
- 75% of clients in Asia are EP, 28% in Latin America
- 71% are women
- Women account for 83% of EP clients
- Repayment rates above 90% on average

MFI Loans: Distinctive Features

- Most distinctive feature: Group lending, joint liability (JL) loans
- However, gradual shift now towards individual liability (IL) loans
- Pure JL loans comprise 19% of market, pure IL comprises 40%, mixed 40%

MFI Loans: Other Distinctive Features

- *Interest Rates:* 20-30% per annum, often going higher if all charges included
- *Small Loan Sizes:* often starting with $25-100 per borrower, could be larger ($300-400)
- *Short Duration:* 3 months – 1 year
- *Frequent Repayment Installments:* weekly, fortnightly, or monthly
- *Repeat Lending:* tie future access to loans (and loan size increases) to repayment of current loans

MFI Loans: Ancillary Features

- Group meetings: weekly/fortnightly/monthly, attended by MFI official
- Savings requirements
- Related training (eg in Indian SHGs) and other requirements (eg voting in Bangladesh)
- Graduated options: longer loan durations, eligibility for small business franchises (e.g., Grameen phone)

Underlying Mechanism

- Main idea: group loans utilize ‘social capital’ in poor communities, as a substitute for collateral
- Social capital resides in local information and mutual dependence within close-knit communities
- *Selection:* create incentives for assortative matching by risk types
- *Monitoring:* by other group members of choice of projects and subsequent effort
- *Repayment:* social sanctions imposed by group members on defaulting members

Related Mechanisms

- *Transaction costs:* administrative scale economies in group lending
- *Savings requirements:* additional screening device (for financial discipline, group dynamics)
- *Gender priority:* women are lower risk borrowers
- *Education:* MFI officials use group meetings as a way to educate borrowers about finance, management, self-control etc.
- *Behavioral/ sociological factors:*
  - financial discipline, overcoming self-control problems
  - intra-household problems
  - Group solidarity, shame, reputation

Critiques, Questions

- *Fiscal sustainability:* most early MFIs were funded by external aid agencies, but are now mostly self-sustaining (many for-profit now)
- *Welfare Impacts:* MFIs usually driven by narrow performance metrics (clientele, repayment rates, % women), what are the effects on lives of borrowers? (Pitt-Khandker-Morduch debate regarding poverty impact and gender impact)
- *Regulatory Issues:* MFIs were traditionally (and still often) unregulated, raising questions about possible usurious or fraudulent behavior
- *Internal Tensions:* problems with group lending emerging, causing shifts in MF practice towards IL loans

Recent Crises and Re-evaluations

- A microfinance crisis emerged in Indian state of Andhra Pradesh (AP) in 2009
- Rigorous evaluation of MFI impacts (based on RCTs) on lives of borrowers (Karlan-Zinman (2009), Banerjee et at (2010)) showed unimpressive results
- Review these next

The 2010 AP Microfinance Crisis

- Explosion in MF lending in AP since 2003: growth in loans from 1 m. to 29 m. in 2010 (SKS goes public in 2009)
- Farmers becoming over-leveraged, collapse of commodity prices
- Reports of farmer suicides, owing partly to repayment pressures from MFI officials
- AP government and politicians urge MF borrowers to not repay loans, label MFIs as loan sharks
- Repayment rates dropped from 98% to 10% in a few months
- AP government shut down industry for a while, RBI committee set up to propose MFI regulations

Karlan-Zinman (2009) RCT-Based Evaluation in Philippines

- Randomly selected three out of four marginally credit-worthy applicants for receipt of MFI (IL) loan in metropolitan Manila in 2007
- Surveys two years later show (treatment-control differences):
  - large increases in borrowing (70-80%)
  - small increases in profit (10%), statistically insignificant
  - *decrease* in business size (no. employees)
  - no effects on fixed assets, savings
  - reduced spending on insurance (esp. health)
  - increases in school enrollment of children
  - no effects on consumption, total income, or self-reported well-being

Banerjee et al (2010) RCT Evaluation in Hyderabad (AP), India

- Randomly chose 52 out of 104 slums in urban Hyderabad for entry of MFI offering classic JL group loans
- Survey treated and control areas 15-18 months later, findings:
  - no significant average effects on consumption
  - heterogenous impacts on those with and without businesses
  - those with existing businesses (10% of borrowers) increased size and profit of business, reduced nondurable consumption (particularly temptation goods)
  - limited increase in new entrepreneurs (10%), but exited thereafter
  - others increased nondurable consumption
  - no effects on education, health or womens role

Related Complaints/Problems with Group Lending

- *Contagious Defaults:* Good risks tend to default when others in the group default, wouldn't have happened with IL loans
- Contagious defaults compounded in times of crisis; heightened instability of MFIs (2010 Kolar case in S India)
- Increased tension within groups, high rates of group dissolution

Other Complaints about MFIs

- Loan sharks?
  - High interest rates
  - Coercive loan collection practices
  - Fraudulent practices (hidden charges)
- Lack of concern for borrower welfare impacts (compounded for for-profit MFIs)
- Limited flexibility in loan durations, frequency of repayments
- No tolerance for risk-taking: borrowers can only invest in low risk-low return projects (small livestock, roadside businesses)
- Onerous ancillary requirements: savings targets, group meetings

Feedback from my MFI Client Interviews in West Bengal

- Most complain that the returns are not high enough to justify the costs of meeting savings requirements, group meetings etc
- Can only finance working capital needs for small low-return businesses that cannot grow much
- MF loans cannot be used to finance agricultural working capital needs, where they most need credit at reasonable cost
- However, possible gains in empowering women and group solidarity (no firm evidence, though)

Other Dimensions of Financial Exclusion: Bank Savings Accounts

- So far have focused on access to one particular financial service: loans
- What about even more basic service: bank accounts?
- Where citizens can accumulate savings that are better protected than in-house cash or grain reserves
- In many LDCs, large proportion do not have a bank account (74%of all households in Nepal)

Protection of Savings, from What?

- Natural disasters (fire, floods, earthquakes,...)
- Theft by outsiders
- Theft by insiders
- Relatives and friends expecting handouts and emergency loans that are never repaid
- Own-temptation to spend on luxuries/temptation goods

Why Are There So Few With Bank Accounts?

- Surveys (e.g., in Nepal): households w/o bank accounts cite the following reasons:
  - distance to nearest bank branch
  - account fees
  - complicated deposit and withdrawal procedures
- Even those with bank accounts use them infrequently (54% less than once a month)

Prina (2014) Experiment with Bank Accounts in Nepal

- To study effects of offering bank accounts with zero charges to women in poor households
- 19 slum areas outside Pokhra, second largest city in Nepal
- Random sample of 1118 female adults (average incomes \$3/day; only 17% had accounts)
- Half of them randomly chosen to receive free bank account offer (no opening, maintenance or withdrawal fees)

Main Results of Nepal Bank Account Experiment

- Large effects on take-up (84%) and use (80% used frequently)
- 8% of weekly income deposited on average 0.8 times per week
- Withdrew accumulated sums occasionally
- No effects on assets or total household expenditures at the end of one year

Results of Nepal Bank Account Experiment, continued

- However, significant effects on *composition* of household expenditures
- Increased spending on education, meat and fish, festivals and ceremonies
- Significant positive effect on self-reported financial situation

Longer Term Effects? Schaner (2014) Kenya Experiment

- Schaner (2014) RCT in Busia, Kenya where participants received 6 month interest subsidy on individual bank accounts (value: 95% less than $1/month, 99% less than $4/month)
- Negligible impact at the end of 6 months on savings, wealth or incomes
- However, at the end of two and a half years later, significant increase in rates of entrepreneurship and nonfarm business profits (27% increase)
- No such effects when offered interest subsidy on joint spousal accounts, or when cash equivalent of the interest subsidy was given as a lump-sum

Summary

- Substantial growth in microfinance industry, NGO dominated
- Achievement: large number of poor clients, mainly women; high repayment rates
- Shortcoming: insignificant effects on incomes or assets or living standards of the poor
- Main effects on allocation and timing of consumption
- Similar findings w.r.t. other financial services such as free bank accounts